RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Nov. 3, 1999 **LETTER 1290**

CHANGES: Dow Jones has decided to "streamline" the Dow. Added to the Dow were Microsoft, Intel, Home Depot and SBC Communications. Kicked out of the Dow were four "old economy" companies: Union Carbide, Goodyear, Chevron and Sears. The Dow will now include two of the highest P/E ratio stocks in its history, and, for the first time, two Nasdaq stocks with super-high P/E ratios. The new additions will mean even a lower dividend yield for the Dow and a higher P/E ratio (of the four new entries, only SBC has any dividend to speak of).

THE PICTURE: I think my original instinct about this bear market and how it would evolve was correct. I opined that the bear market was going to begin with an **extended period of (erratic) erosion.** Most people equate a bear market with a dramatic crash as per 1929. A crash is not very subtle; in fact a crash amounts to an advertisement for a bear market. I didn't think that was going to happen, at least in the early phase of this bear market. And it hasn't.

No, the more subtle and the more diabolical way would be a long and **costly period of erratic (volatile) erosion** -- accompanied by a few "hot" areas which would serve to mask the erosion. So here's the bear's strategy -- continue the deterioration in breadth, with the great majority of stocks sinking week after week -- but the declining trend in the majority of stocks is masked by the good action in a few very visible groups of stocks -- mainly the techs and the internets.

Of course, what's happened so far has even raised questions of "Is this really a bear market or is it just a complex correction?" This kind of question, of course, is exactly what the bear wants. To question whether it's even a bear market means that stockholders are very tempted to remain in the market, to resist selling their stocks. The public is further encouraged to hold on to their stocks with the help of the constantly expressed advice that "it pays to hold stocks for the **long term."**

I note that almost all the talk these days is of individual stock action, news of quarterly earnings ("up a penny above expectations") or what the Fed may or may not do. At the same time, there's little or no informed discussion of the primary trend of the market.

The irony, of course, is that there's nothing more important to investors than the major or primary trend of the market. But the primary trend remains hidden to most observers, buried amid the current excitement over spot news stories, rumors and endless earnings reports and "expectations."

Question: Would you rather buy a good stock during a bear market or a bad stock during a bull market?

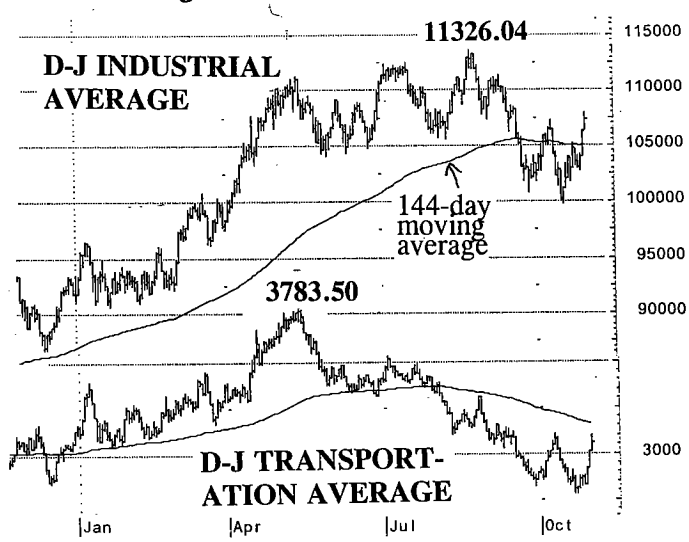
Oct. 21 DJIA 10297.69; PTI 5229; A-D Ratio -3.50
Oct. 28 DJIA 10622.53; PTI 5231; A-D Ratio -3.10
Dow Yield: 1.63%; Dow Price/Earnings: 22.0
Dow 144-day MA: 10499; Dow 34-day MA: 10507
Dow Times Book Value: 6.34; PTI 89-day exp. MA: 5292
Percentage of Undervalued Blue-chips: 9%
Gold 34-day MA: 296

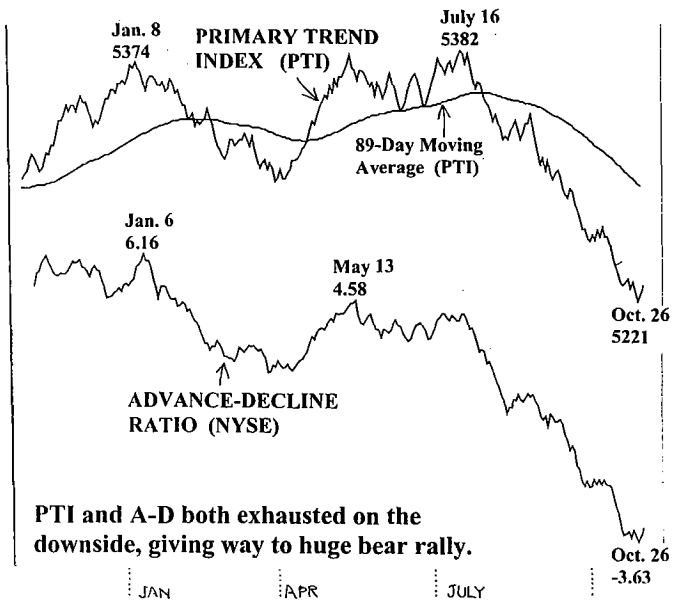
Answer: Of course, I'd prefer to avoid either one, but if forced to pick one or the other, I'd pick a bad stock in a bull market. The reason: Good things happen in a bull market, and price/earnings rise during a bull market. Therefore, if I buy a bad stock in a bull market there's a chance that someone will take over the bad stock and turn it into a good stock. Example, Warren Buffett took over the old Berkshire Hathaway defunct textile company, turned it into a holding company and, lo and behold, it became a "wonder stock."

Conversely, in a bear market, before it's over, almost all stocks will decline, with obviously the bad stocks going down further than the good stocks. One reason for this is that price/earnings go down in a bear market, so even a good stock that is selling for say 30 times earnings at the top of a bull market will still be a good stock in a bear market, but it will be selling at 14 times earnings, and that could easily cut its price 50%.

Transports: On October 20 the D-J Transportation Average broke to a new bear market low -- as of October 20, Transports were down a full 26% from their high. The Transports were the first to render their half of a Dow Theory bear market signal, and it appears to me that the Transports are continuing to lead the way down.

During the early part of a bear market the downside penetration of one Average is usually followed by a confirming penetration by the other. Which is why I expect the Dow to follow the Transports down to new lows, **but in its own good time.**





In the very **late stages** of a bear market, the penetration of one Average, **unconfirmed by the other**, will often signal the end of the bear market. This is exactly what happened in 1974 when the Transports hit a bear market low in October. In December the Dow broke to a new low but the Transports refused to confirm. That downside non-confirmation signaled the end of the bear market.

Do I think the new Transport low of October 20, unconfirmed by the Dow, signals an end to the bear market? No I don't, rather I believe that in due time the Dow will follow the Transports down to new bear market lows.

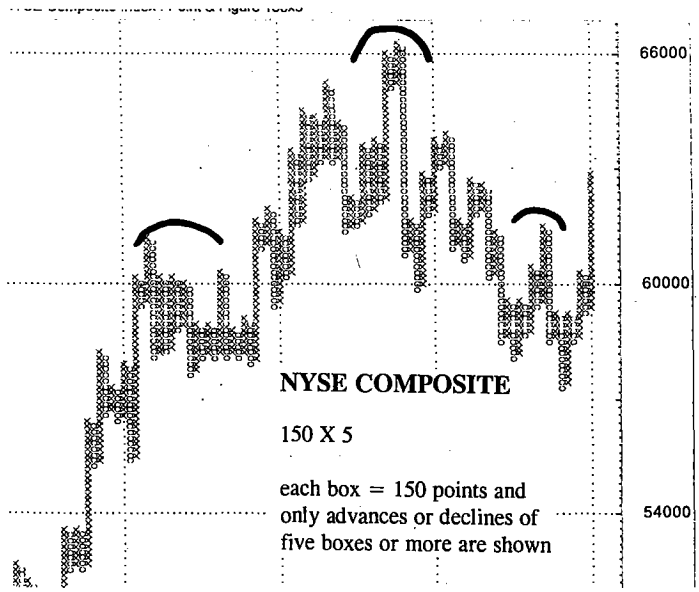
Note: In a **bull market**, sudden bad news often sets off buying in a stock on the thesis that "now the bad news is out, so this is the time to accumulate the stock while it is still cheap." But in a **bear market**, sudden and unexpected bad news will often set off a crash in an individual stock. This is what we've seen recently in a long list of stocks -- recent examples are IBM, EBAY, Raytheon, Hewlett-Packard, Unisys, Gillette, and Xerox.

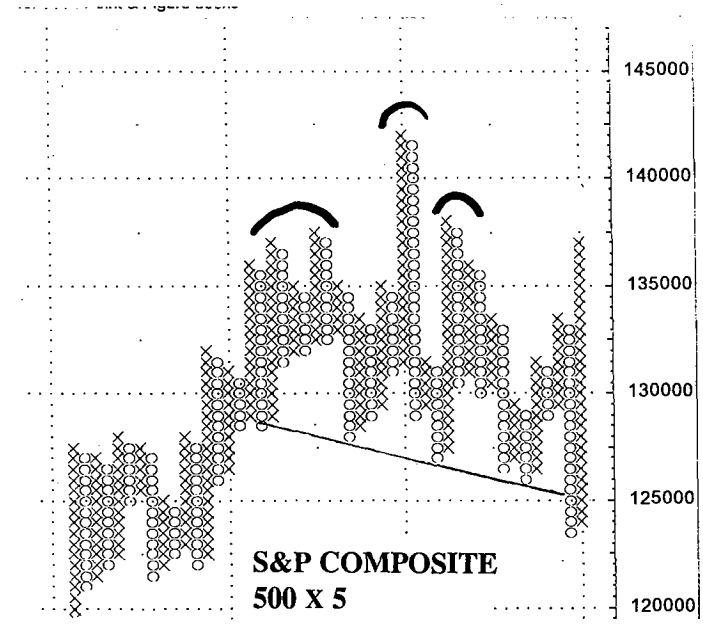
Major tops appear to be in place: Point & figure charts can often clarify a complex and convoluted picture. I'm including P&F charts that show major tops. Of course, anything can happen in this business, but it certainly would surprise me if any of these tops were bettered in the period ahead.

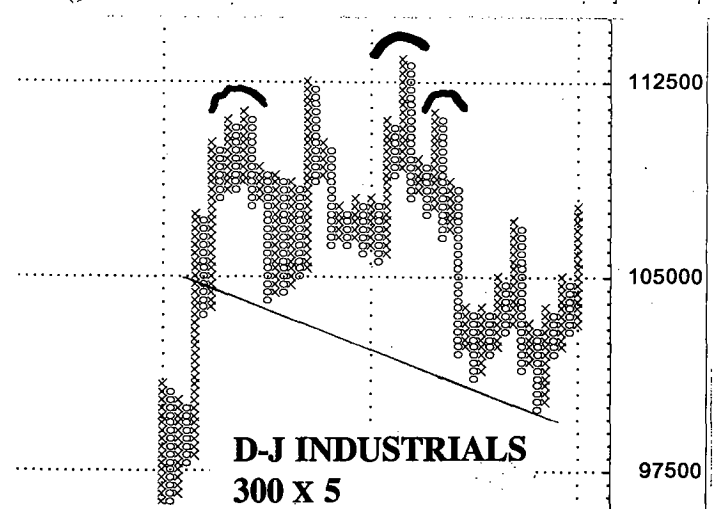
The first chart (page 2) shows the broadest average, the **NYSE Composite,** and this includes **all the stocks on the NYSE.** This top has assumed the form of large "head-and-shoulders" pattern. The main support was broken recently, and, as this is written, the NYSE has turned around and is chewing into supply again.

The next chart deals with the **S&P 500.** Here again we see a head-and-shoulders pattern. And again the support has been temporarily penetrated. Once support is broken, everything above support becomes supply. Thus, the latest action shows the S&P reversing to the upside and pushing up into massive supply.

The next P&F chart shows the breakdown of the **Dow** below the 10,450 level, the subsequent slide down to





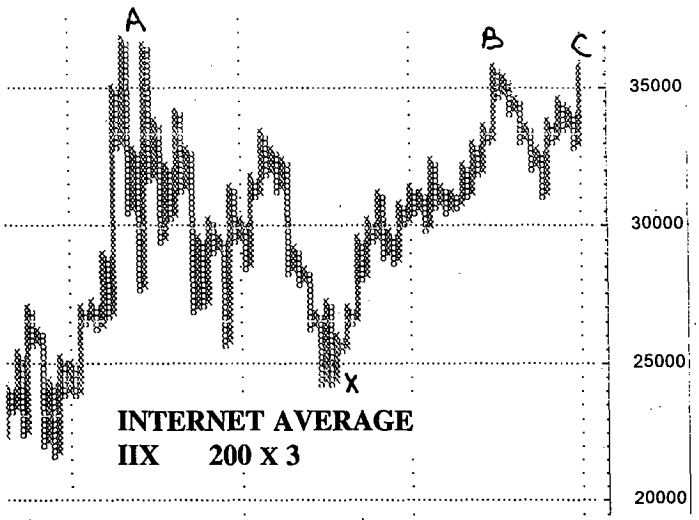


10,000 and the most recent rally. As in the case with the others two averages, we see the Dow climbing back into supply.

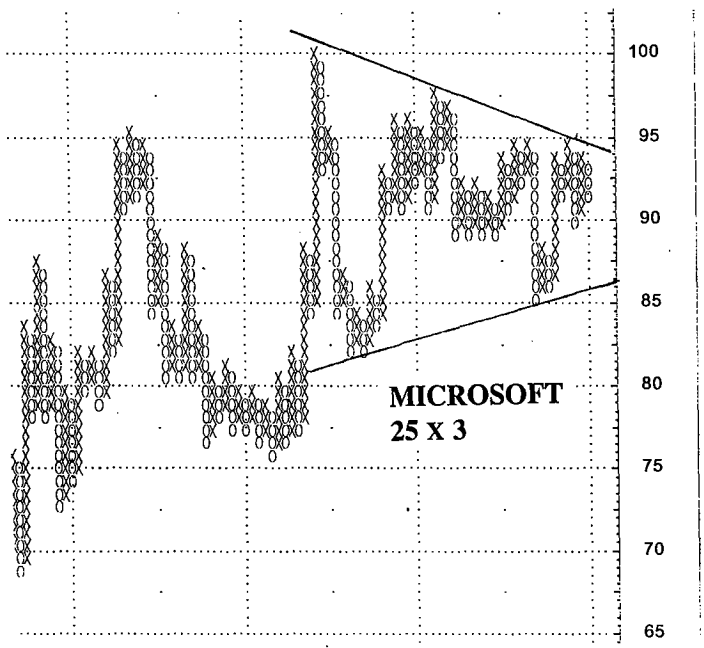
In each instance the pattern is clear -- it's a process of **continuing attrition** -- with each rally peak ending below the preceding rally peak and each decline low breaking

below the preceding decline low. Which, of course, is the definition of bear market action.

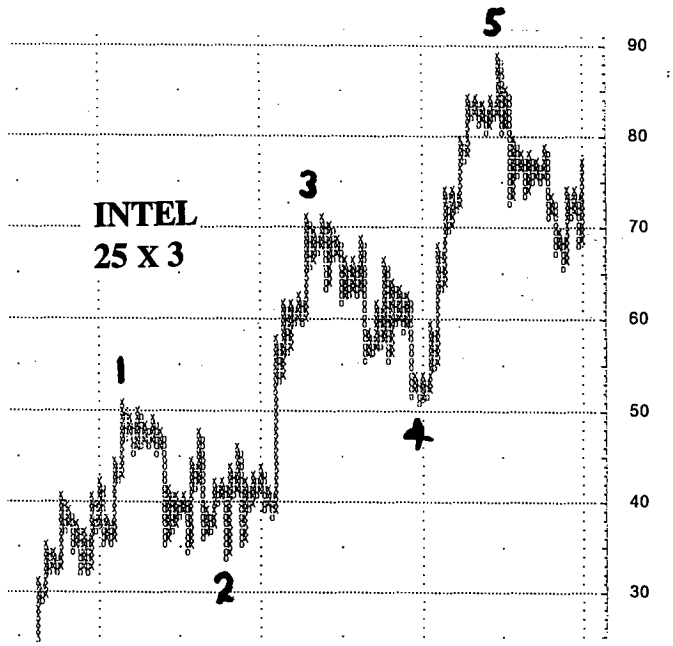
The next chart shows IIX, the very important Internet Average. What I see here is three declining peaks with critical downside support at 310. Above 358 and IIX will try for the highs. But below 310 I'd say that the net stocks have topped out -- and this would have dramatic implications for the entire stock market.



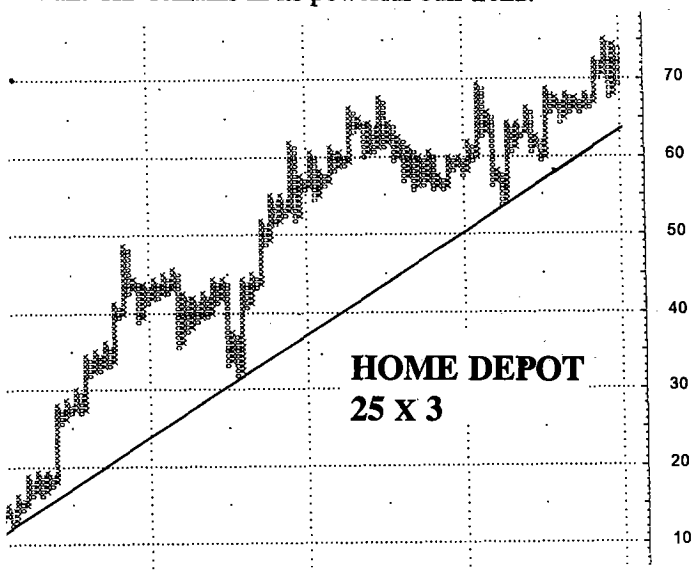
Let's look at the new Dow Additions: Microsoft has traced out a huge symmetrical triangle. This is a pattern of indecision. Let the price action tell us which way MSFT is heading. MSFT above 95 would look very promising and would suggest a testing of the high. But MSFT below 85 would suggest an ominous breakdown. Below 85 and MSFT would be on the way to testing 80 and below. My guess -- MSFT is in the process of topping.

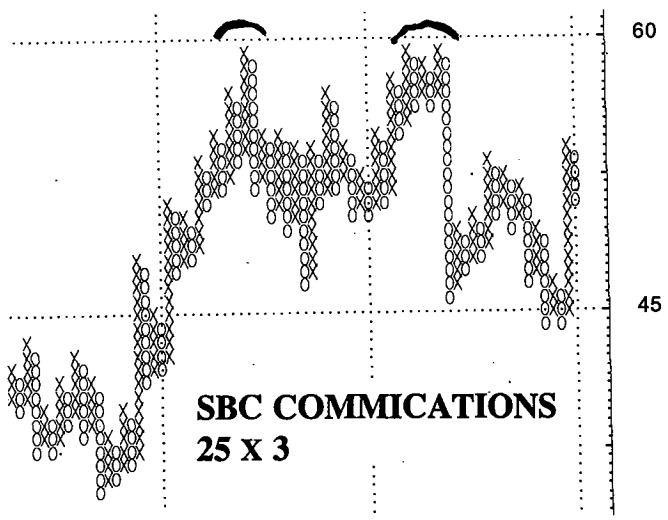


Intel is interesting. What I see here is a five wave rise (three waves up and two corrective waves down). A move to point 5 often completes an entire rise. We'll see if that applies to INTC. I think it does, which means INTC is in a topping-out process. A close below 65 would spell the end.



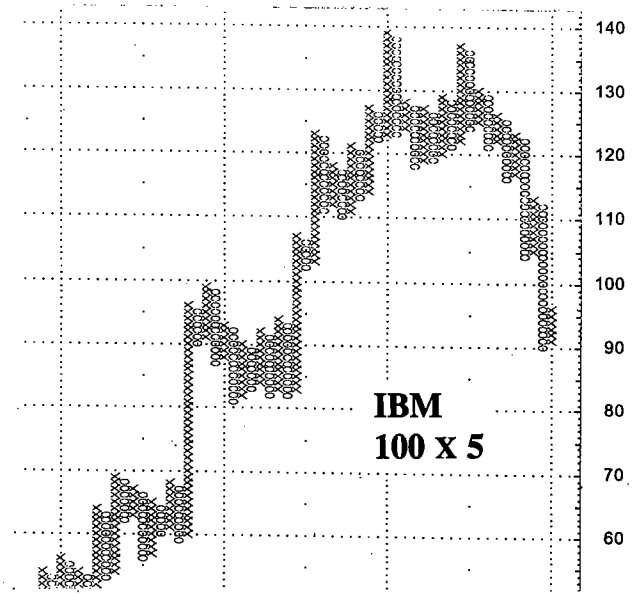
Home Depot's trend is clearly bullish, and this is a stock that I'm going to classify strictly on the basis of its trendline. A decline to 61 would break the trend -- above 61 and HD remains in its powerful bull trend.



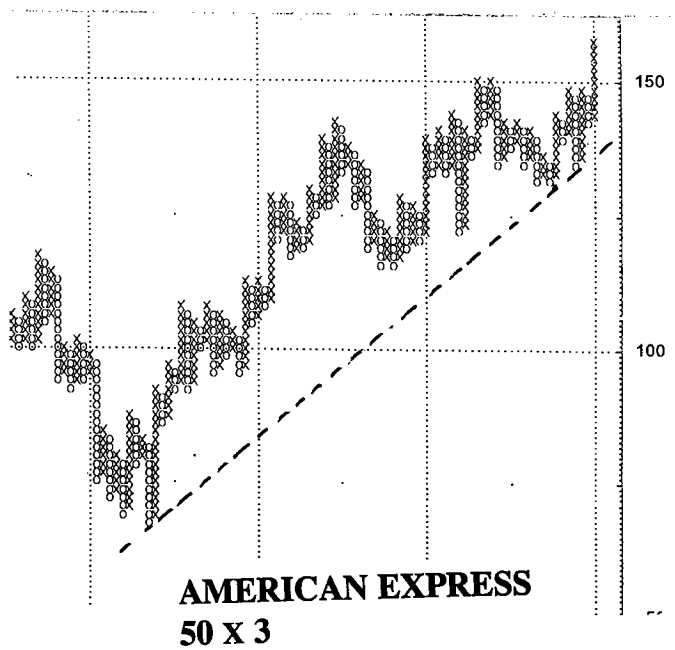


SBC formed a double top in the 59-60 area, then broke down to 44. This is clearly a topping-out pattern. The latest rally simply pushes the stock back into supply. It would take a rally above 54 to even begin to turn SBC bullish again.

How about the highest-priced items in the Dow? These are the stocks that can really move the Dow. First, we see **IBM.** As I see it, the stock has topped out. When the stock broke 110, that was it. From there IBM sank to the 90 box, and it is now in the process of reclaiming a bit of its recent losses.



There's no question about **American Express,** AXP is clearly bullish. The recent surge above 150 leaves AXP "in the clear," free to push as high as it wants. A first sign of trouble would be a decline back below 150.



INVESTMENT POSITION: The breadth or advance-decline ratio action is so rotten, that even the bulls have been wondering what's going on. If they read these reports they can stop wondering -- this kind of breadth collapse is only seen in bear markets. An old adage tells us that "one picture is worth a thousand words." Please accept this picture of a bear as worth at least a thousand words, maybe even more.

As of last week, the breadth decline had reached almost 17 points and, even in a bear market, this is extreme. Thus the rally came as no surprise.

Bonds may have bottomed. I continue to recommend T-bills and treasury notes out as far as 10 years.

NOTES & QUOTES: Checking the four additions to the Dow and the four that were jettisoned, Intel is up 21% this year, while Chevron was up 6%. Microsoft was up 33% this year, while Union Carbide was up 39%. SBC was down 15% this year, while Goodyear was down 18%. Finally, Home Depot was up 16%, while Sears sagged 37% . . . The Dow is a price-oriented average. The most expensive stock in the Dow is AXP, now at 144 a share, so AXP will have a greater effect on the Dow than MSFT (price around 92), although MSFT has a market value of five times AXP.

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There was a very interesting and very insightful column in the November 1 issue of *Forbes* magazine, a column by Jeremy Grantham entitled, "Dow 3600." Here are a few excerpts: "Unfortunately, there's little doubt that today's US market performance is a bubble. The ratios of stock market capitalization to dividends, earnings, replacement costs and GDP are all 30% to 50% above their levels in the bubble highs of 1929 and 1965. Sooner or later, the current bubble will burst. . . . At a recent meeting of 140 money managers, I asked the crowd for a yes-or-no vote on whether they agree with me on two forecasts for the next 10 years: that the market P/E would drop from today's 32 to 17.5, and that profit margins would drop from the current 7.2% to 6%. This knowledgeable group was well aware that the 70-year average for P/Es and margins were way below 17.5 and 6%. So they voted unanimously that both numbers would decline. But paradoxically, a substantial majority of this group also voted that the market would continue to show satisfactory returns. That may be logically inconsistent, but it's apparently typical of human behavior in times such as this. Such an outcome, of course, is simply impossible. . . . Have any bubbles survived? Has there ever been a new era? No. My colleagues looked at every big asset class this century -- gold, oil, cocoa, dollars, yen, pounds, stocks. Each one had at least one bubble and each bubble gave back all its gains, reverting to the mean. . . . More likely than Dow 36,000 today is Dow 3,600, requiring a retreat to a 12.5 P/E and a 5.2% profit margin, both well above the levels of 1982, the last serious bear market."

Russell Comment: Could the Dow retreat in this bear market to 3,600? Consider this: Many bear markets brought the market down to the point where the dividend yield for the Dow was 6%. If the Dow was now to decline to the 6% yield level, then based on current dividends the Dow would decline below 3000 -- this without any dividend cuts; if, on

the way down, any Dow dividend cuts appear, those cuts would take the Dow even lower.

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I thought this was a fascinating chart (bottom of page). It traces the Dow yield back to 1928. Here you see that there were 12 instances when the Dow declined to the point where it provided a yield of 6% or more. Could this ever happen again? My advice: Don't bet against it.

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The Achilles heel of the market could be the dollar. And the negative current and trade balances do not bode well for the dollar. The excellent **Klein-Wolman** letter has some interesting words on this: "The growing trade deficit has been a non-issue in the financial markets. US consumers have been able to buy abroad and foreign investors have financed these purchases by building up their dollar holdings. . . . The US is becoming less attractive. And if US stock prices begin to decline, then consumers here will realize the need to save out of current income in order to increase net worth. Consumers will need to become net savers. The bottom line is that the chronic trade deficit will have to be reduced and the path to reducing it will not be pleasant. It may require higher interest rates in the US, or a reduction in consumption, or a decline in the value of the dollar. None of these alternatives are favorable for the US stock market. Eventually, the US will have to boost its savings rate. At the current pace, by the year 2000, a savings short US economy will have to import $1 billion of foreign capital per day to support its spending habit. The rest of the world believes that we are living beyond our means. They are correct, but at the same time they have been willing to finance our spending. A sharp decline in the dollar will signal that foreign investors are no longer willing to finance our consumption."

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My old friend, Joe Granville, has been very right on this market, so far, and in his last report he ventures the following: "You were told here in August right at the top that most stocks could be sold then and bought back later at lower prices. **I look for the Dow to go to 6,000 within six to 10 months." Russell Comment:** Joseph is one of the very few analysts who believe this is a major bear market.

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Thoughts on the nets: So far, every major net site is in the race to accumulate click-on viewers. The goal -- **to establish brand name.** So far, the net companies are spending most of the money they're bringing in on advertising -- with many simply advertising on other net sites. For instance, Hotjobs raised $20 million selling a piece of itself in August and it's spent $20 million on ads. The coming Super Bowl (cost for a 30 second ad -- $2 million) has 60 slots for ads and it has already sold 25% of its ad slots to dot.com companies, two to Hotjobs and two to its rival, Monster.com. One of the best known sites, E*Trade, in the highly competitive brokerage arena, will spend $150 million on ads or about 25% of its revenue.

Turning over the pages of the *NY Times* or the *WSJ* and I see page after full-page ads for various .coms. It's almost ridiculous. I'm not going to use 99% of these web sites; I can't even remember most of them. I think it's going to be like cold cereals; at one time there were dozens of them, you couldn't keep up with all of them. Now there are about six or eight big sellers. Today there are countless Internet sites. They are spending hundreds of millions of dollars advertising on each other's websites and in major newspapers. In the end, I believe there will be maybe two dozen or fewer major websites. The rest will either go out of business or merge (although there will be hundreds of specialty sites, which will simply be there on hopes or because there will be enough specialty interest to keep them in business).

When I was a kid every family's dream was to have a full set of the Encyclopedia Britannica which was very expensive, costing, as I remember, over $1,000 second hand (the price now is $1250 in book form). Last week the Encyclopedia announced that it's putting its entire 32 volume on the Internet -- free. How can they do it and survive? They expect to stay profitable by selling advertising. Advertising, evidently, is fated to hold up the entire Internet economy.

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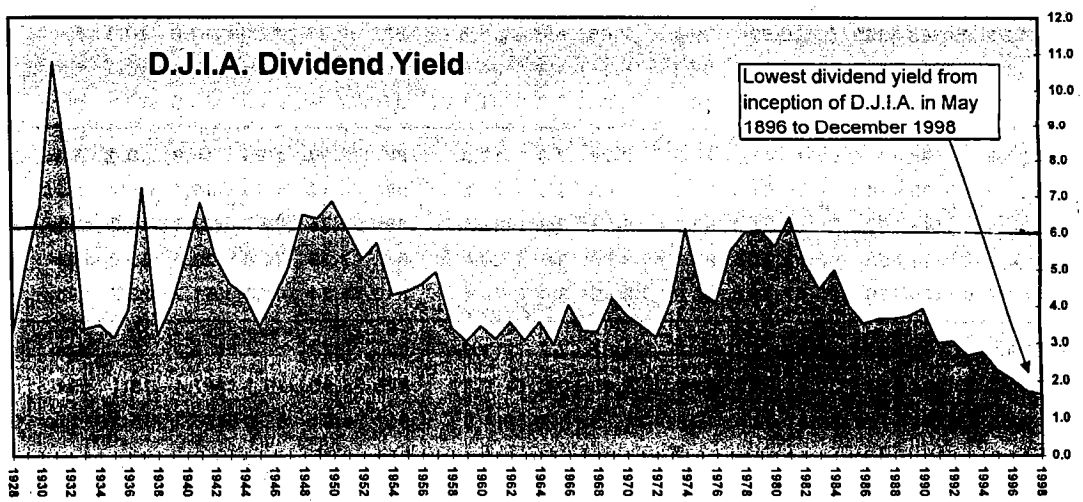
Two things that are sure, "death and taxes." But even death (at least early death) is not that sure any longer, to the despair of the funeral business. The industry is now suffering as large chains are struggling to finance overpriced acquisitions and as the US death rate has slowed. The $14 billion funeral business' three biggest chains generated big profits as they bought up almost half of all Southern California's funeral homes and 13% of all US funeral homes. But this year it all changed. The second biggest outfit, Loewen Group of Canada, filed for bankruptcy, while shares of the other "big three," Service Corp. International and Steward Enterprises lost three-quarters of their value. **Russell Comment:** What happened? They paid too much for their acquisitions while at the same time consumers opted for minimalist and inexpensive burials or cremations.



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In my opinion, the odds for a Chinese devaluation are increasing. China is suffering from deflation and declining state investment. Furthermore, China's economic growth declined in the third quarter. The Chinese economy's main problem is a deflationary trend which entered its 24th month in September, when

retail prices fell 2.8%. The deflation has hit corporate earnings and created hesitancy in consumer spending as they now expect lower prices ahead.

In contrast, I was studying the real estate section of the *NY Times* magazine section. The prices of apartments and condos in the many new buildings are staggering. Apartment prices of $2 to $10 million and above are common. The same issue of the *Times* (Sunday, Oct. 24) has a front-page article on a "household management" company that prepared people for jobs as butlers or household manager. These jobs, according to the article, command salaries of $60,000 to $120,000 a year in Manhattan.

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The One Penny Racket: This article appeared in the Oct. 24 *NY Times*. It talks about the ridiculous and very prevalent corporate policy of managing earnings. For instance, have you noticed how many earnings come in exactly one cent above "expectations?" Writes the *Times*, according to Thomson/First Call, of the 311 S&P companies that have reported earnings of the third quarter, 21.5% beat their estimates by one cent. In each of the last six quarters, 18% of companies, on average, beat their estimates by a penny. **Russell Comment:** Totally ridiculous. But the public, it seems, is accepting it.

The Earnings Waltz: Is the Music Stopping?

ALMOST two out of three companies in the Standard & Poor's 500-stock index have reported earnings that exceeded analysts' expectations for the third quarter. So why is the index itself up only 1.47 percent since the quarter ended?

ings forecast. The more help they received, the less work they did.

This dance went smoothly for awhile. Companies met or beat the analysts' estimates and their stocks went up.

Now, however, many companies who had

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Writes the usually bullish *Business Week* (Nov. 1) in its editorial, "America's obsession with the ups and downs of the stock market is obscuring what may be far more important happenings in the debt markets. An enormous borrowing binge is underway in the economy's private sector that makes it surprisingly vulnerable in the months ahead. . . . non-Federal borrowing has jumped $1 trillion since 1992, rising from 3.1% of the GDP to nearly 13% today. . . . While talk of a 'bubble' economy grabs attention, it is debt that may be exploding beyond control." **Russell Comment:** I continue to think that this is the Achilles heel of this economy. If consumers turn cautious and start saving, you're going to see corporate profits slide in earnest. And that may be what the long slide in the advance-decline ratio is telling us. . . . Incidentally, a recent study shows that the average US family cannot raise as much as $1,000 in cash.

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Story: Two hippies in 1994 start a company that creates electronic greeting cards. The company makes no profits, the cards are given away. The couple calls their company Blue Mountain Arts Publishing. Last week Excite@Home bought the company for $1 billion -- $350 million cash and the rest in stock. Excite@Home (majority owned by AT&T) claims that the new acquisition will increase its net audience by 40%. They didn't say anything about profits. But the acquisition will allow Excite to increase what it charges advertisers.

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A study by *USA Today* shows that the net stocks have issued a huge blizzard of options for employees. "The potential dilution in the Internet world is huge. Employees exercising stock options will shrink the value of existing shares by 24% in less than four years."

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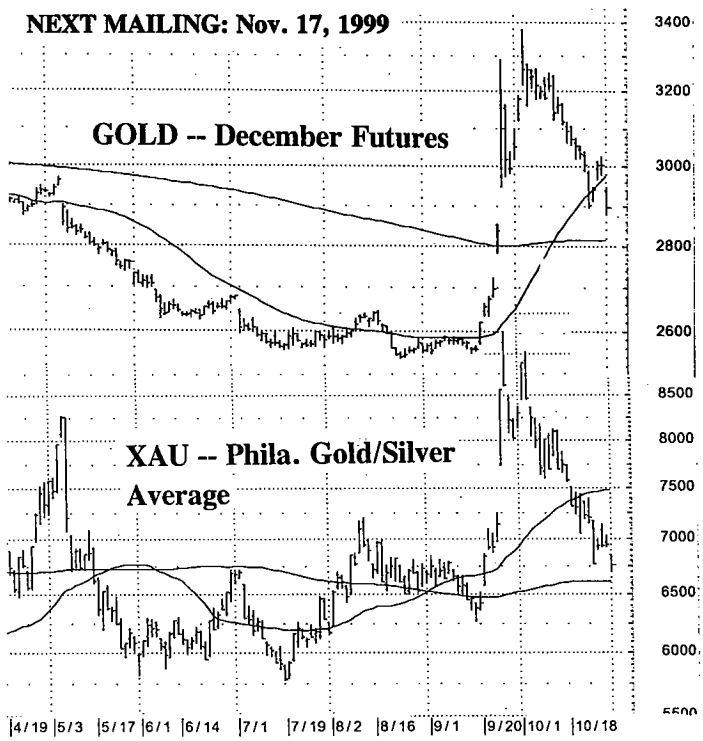
GOLD: There's always a great deal of emotion connected with gold, and I'm afraid that this emotion interferes with a cold analysis of the price action. I prefer to keep it cold and unemotional. The action has been discouraging. The recent explosive action switched the two moving averages into the bull mode with the 34-day MA rising above the 144-day MA. Last week, Dec. gold declined to test its 34-day MA, and the test looked OK. But XAU, the Gold/Silver Average, broke below its 34-day MA and actually sank below its August high. Not good for the stocks.

Then on Monday we got action that I felt was discouraging. Gold gapped down, dropping over 10 points and falling to a new low well below its 34-day MA. Worse, XAU also gapped down to test its 144-day MA. Conclusion: Of course I want to see more, but the picture is turning dimmer for gold.

NEXT MAILING: Nov. 17, 1999



LATE NOTES: From its April 1998 high to its October '99 low, the advance-decline ratio lost 16.63 points, a huge decline. From its July high of 5382, the PTI dropped to an October low of 5221, a huge drop of 161 points (page 2 chart). The extended collapses of these two left the stock market exhausted on the downside with a record short interest. The result -- an explosive bear market with massive short covering. Of course, the tremendous rally has left the A-D ratio, the PTI and most broad stock averages behind -- all unable to even begin to confirm. But the lesson is clear -- there's nothing more explosive, more dramatic, than a bear market rally.

The ultimate result will be trouble stemming from the many non-confirmations. More immediately -- watch to see whether the Transports can rally above 3100. If they can't, the rally could be in trouble.